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Mass. Gen. Laws ch. 93A and the Defense of In Pari Delicto

On June 22, 2006, the United States Court of Appeals for the First Circuit decided *Baena v. KPMG LLP*,[1] holding that the *in pari delicto*[2] doctrine barred claims under Mass. Gen. Laws ch. 93A §§ 1-11 (2002) brought by a litigation trustee against a bankrupt company's outside auditors.[3]

I. FACTS AND PROCEDURAL HISTORY

Lernout & Hauspie Speech Products, N.V. ("L&H") was a Belgian company with its U.S. headquarters in Massachusetts. It developed and licensed speech recognition software. L&H reported tremendous growth in its revenues and profits from 1998 to 2000 and acquired two U.S. companies in March 2000. It took on substantial new debt to do so.

L&H filed for Chapter 11 reorganization following disclosure that revenues in its previously reported financial statements had been materially overstated. Certain officers and directors were implicated in apparent wrongdoing, and are awaiting trial in Belgium on charges of fraud, insider trading and stock manipulation. The bankruptcy court approved a plan of liquidation which authorized a litigation trustee appointed by a committee of unsecured creditors to prosecute claims on behalf of L&H.

In August 2004, the trustee brought an action against L&H's former auditors, KPMG, in federal bankruptcy court in Delaware. The action was transferred to the federal district court in Massachusetts. The trustee asserted claims against KPMG for aiding and abetting breach of fiduciary duty, ac-

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1 No. 05-2868, 2006 WL 1703822 (1st Cir. June 22, 2006).

2 *In pari delicto* means "in equal fault." BLACK'S LAW DICTIONARY 806 (8th ed. 2004). The doctrine is commonly employed as a defense in tort cases where a deliberate wrongdoer is attempting to recover from a co-conspirator or accomplice. *Baena*, 2006 WL 1703822 at 4.

3 Chapter 93A, § 11 provides a civil cause of action for any person who suffers any loss of money or property after engaging in business-to-business transactions with another person employing unfair methods of competition and unfair or deceptive acts or practices. Fault beyond mere negligence is required. *Id.* at 1.

counting malpractice, and violation of Mass. Gen. Laws ch. 93A. On KPMG's motion to dismiss, the district court found the first two claims untimely and the third barred by *in pari delicto*, and dismissed the action. On appeal, the trustee challenged only the *in pari delicto* ruling in respect of his chapter 93A claim. Applying Massachusetts law, the Court of Appeals affirmed dismissal of the trustee's action.

II. RATIONALE OF THE COURT (PER BOUDIN, C.J.)

The trustee alleged "that KPMG had wide access to L&H's financial records and activities; that despite discovering and in some cases warning managers of serious problems, KPMG failed to alert the independent directors of L&H and instead issued unqualified opinions and certified balance sheets and operating statements of L&H for fiscal years 1998 and 1999; and that these actions permitted L&H to proceed with the [acquisition of two new companies], thereby incurring $340 million in new debt which after the disclosures it could not repay."[4]

The Court of Appeals, however, characterized the action differently. "What the trustee has charged under chapter 93A is essentially a fraud, knowingly tolerated or abetted by KPMG, but primarily one committed by L&H's own management in misstating its earnings. . . . Here, assuming fraudulent financial statements, senior L&H management were, on the trustee's own version of events, the primary wrongdoers. Thus, in the ordinary course, Massachusetts courts would not allow L&H managers to sue a secondary accomplice such as KPMG for helping in the [wrongdoing]."[5]

In pari delicto is a long-standing doctrine based on the policy that "courts will not lend aid to parties who base their cause of action on their own immoral or illegal acts."[6] The issue faced by the Court of Appeals was whether to impute the primary wrongdoing of L&H's managers to the company itself so as to bar the trustee's claim against KPMG.

The Court of Appeals noted that approval and oversight of financial statements is an ordinary function of management that is done on behalf of the company and is usually enough to impute management's actions to their employer, and found nothing to indicate that Massachusetts would take a narrower view of imputation when considering the doctrine of *in pari delicto*.[7]

The trustee argued that the management's actions should not be imputed to the company if the wrongdoing was "adverse"[8] to the company's interests. The Court of Appeals rejected the argument. "A

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4 *Id.* at 2.

5 *Id*. at 4-5.

6 *Choquette v. Isacoff*, 836 N.E.2d 329, 332 (Mass. App. Ct. 2005).

7 *Baena*, 2006 WL 1703822 at 5.

8 A manager's actions are "adverse" to the company when his motivation is to benefit himself or a third

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fraud by top management to overstate earnings, and so facilitate stock sales or acquisitions, is not in the long-term interest of the company; but, like price-fixing, it profits the company in the first instance and the company is still civilly and criminally liable."[9]

The trustee also argued that the doctrine of *in pari delicto* should not apply if "innocent decision-makers," such as independent directors of the company, could have prevented the harm if they knew about it. The Court of Appeals found this argument unpersuasive, characterizing it as one that clearly deviates from traditional agency doctrine.[10]

The Court of Appeals stated that probably the best argument for reversal is that, recognizing recent reforms to the federal securities laws and the role of independent auditors to alert a company's audit committee to management wrongdoing, Massachusetts could choose to expand the prospect of civil liability for defaulting accountants by limiting the use of the *in pari delicto* doctrine in cases such as the one before it. The Court of Appeals listed the factors to be considered (including the need for increased incentives for auditors to expose wrongdoing and the cost of increased pricing of accounting services), but ultimately concluded that changes in existing law should come from the Massachusetts authorities.[11]

III. SIGNIFICANCE OF DECISION

While Massachusetts courts readily apply the long-standing doctrine of *in pari delicto* to tort cases, its application to chapter 93A claims is a recent development. The Court of Appeals' reaffirmation of *in pari delicto* as a defense against chapter 93A claims should be of interest to third party professionals such as bankers, accountants and lawyers in the current environment.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Charles A. Gilman at (212) 701-3403 or cgilman@cahill.com; Jonathan I. Mark at (212) 701-3100 or jmark@cahill.com; or John Schuster at (212) 701-3323 or jschuster@cahill.com.

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party, and not the company. Defalcation is an example. *Id.* at 6.

9 *Id.* at 5.

10 *Id.* at 6. A few trial courts in the Second Circuit have recognized the "innocent decision-maker" doctrine as a bar to *in pari delicto* defenses against a bankruptcy trustee seeking to recover against outside professionals, but the Second Circuit has reserved the issue. *Id.*

11 *Id.* at 7.